National Taxpayer Advocate

2009 Annual Report to Congress

# Subsequent Compliance Behavior of Delinquent Taxpayers: A Compliance Challenge Facing the IRS

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## Executive Summary

In this study, TAS Research examines the subsequent compliance behavior of individual taxpayers who incurred failure-to-pay delinquencies in 2002 following the last recession.[1] The study includes only taxpayers who had no prior unpaid tax liabilities at the time that they acquired their delinquencies. We chose this group because we believe its subsequent compliance behavior is indicative of the likely subsequent compliance behavior of the many taxpayers entering into delinquency during the current economic downturn.

The study tracks the compliance history of this cohort of taxpayers from the time their delinquencies began in 2002 through the first quarter of 2009. We explore the following questions:

- Was the IRS effective at keeping taxpayers compliant after the initial IRS disposition of their original liabilities?
- Does a financial analysis based solely on IRS allowable living expense (ALE) standards adequately capture the taxpayer's financial situation, or does it contribute to subsequent noncompliance?

The study then briefly reviews conditions in the current environment to assess the compliance challenges confronting taxpayers and the IRS.

### FINDINGS

Taxpayers whose accounts were placed in the IRS Collection queue or in currently not collectible (CNC) status at first disposition had high levels of subsequent noncompliance. In addition, all taxpayers whose liabilities reached taxpayer delinquent account (TDA) status and were worked in the Automated Collection System (ACS) or by the Collection Field function (CFf) had especially high levels of subsequent noncompliance, regardless of their dispositions, as did taxpayers who had cancellation of debt income (CODI) or experienced bankruptcy at any time during the study period.

- **Taxpayers placed in queue:** About 54 percent of these taxpayers had subsequent payment delinquencies. About 76 percent had at least one subsequent payment delinquency or unfiled return.
- **Taxpayers placed in CNC status due to hardship:** About 45 percent of these taxpayers had subsequent payment delinquencies. About 59 percent had at least one subsequent payment delinquency or unfiled return.

[1] The recession preceding the current economic downturn ended in November 2001. National Bureau of Economic Research, *US Business Cycle Expansions and Contractions*, *available at* http://www.nber.org/cycles/ (last visited Nov. 25, 2009).

- **Taxpayers whose liability reached ACS or CFf:** Slightly over half of these taxpayers had subsequent payment delinquencies. About 74 percent had at least one subsequent payment delinquency or unfiled return.
- **Taxpayers who had CODI or experienced bankruptcy:** Over 61 percent of these taxpayers had subsequent payment delinquencies. About 68 percent had at least one subsequent payment delinquency or unfiled return.

A simulated financial analysis based on the ALE standards shows that taxpayers (particularly those whose accounts were placed in CNC status or who received CODI or experienced bankruptcy) have financial obligations that are not included in the standard ALE analysis. This finding suggests that many taxpayers may have liabilities that the IRS will not allow in its calculation of the taxpayers' ability to pay (*i.e.*, unsecured debt, or housing expenses that exceed the ALE allowance).

These liabilities could contribute to subsequent noncompliant behavior, since the amount the taxpayer is required to pay to the IRS may put some taxpayers in the position of deciding which creditor they will pay.

## RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS study a representative sample of taxpayers with new payment delinquencies to determine the extent to which they have liabilities that are not allowed under current ALE standards. The study should also evaluate whether IRS installment agreement (IA) policies would cause these taxpayers to default on non-IRS liabilities.

If the study results confirm that current IRS IA policies are problematic, the National Taxpayer Advocate recommends that the IRS conduct a pilot study in which taxpayer payment agreements are based on a comprehensive review of the taxpayer's financial situation, with due consideration to all taxpayer liabilities.

The National Taxpayer Advocate also recommends that the IRS study the use of collection alternatives, such as the offer in compromise (OIC) program and partial payment installment agreements, in lieu of placing taxpayers in CNC status.[2] The agreements could be structured to have a finite duration and a flexible payment schedule contingent on the taxpayer's ability to pay throughout the duration of the agreement. The emphasis would be on ensuring that taxpayers remain current on future tax liabilities through the establishment of adequate withholding, or periodic direct debit estimated payments (*e.g.*, on a bi-weekly or monthly basis) for self-employed taxpayers.

[2] For a detailed discussion of the IRS OIC Program *see* Most Serious Problem: *The Steady Decline of the IRS Offer In Compromise Program is Leading to Lost Opportunities for Taxpayers and the IRS Alike*, Vol. I, *supra*.

## Introduction

The current economic environment is placing severe financial stress on many taxpayers. This situation is reflected almost daily in media reports of prominent economic indicators, such as the unemployment rate, mortgage delinquencies and foreclosures, and depressed levels of private consumption. The National Taxpayer Advocate is concerned about the impact of these challenging conditions on taxpayers. She directed TAS Research to explore whether the downturn is significantly undermining taxpayers' ability to comply with their tax obligations.

This study examines the subsequent compliance behavior of individual taxpayers who incurred failure-to-pay delinquencies in 2002, following the last recession.[3] The study includes only taxpayers who did not have prior unpaid tax liabilities at the time that they acquired their failure to pay delinquencies. A total of 6,200,289 taxpayers met these criteria and were included in the study. We chose this group because we believe their subsequent compliance behavior is indicative of the likely subsequent compliance behavior of the many taxpayers entering into delinquency during the current economic downturn.

The study tracks the subsequent compliance history of this cohort of taxpayers through the first quarter of 2009. We explore the following research questions:

- Was the IRS effective at keeping taxpayers compliant after the initial IRS disposition of their original liabilities?
- Does a financial analysis based solely on IRS allowable living expense standards adequately capture the taxpayer's financial situation, or contribute to subsequent noncompliance?

The study then briefly reviews conditions in the current environment to assess the compliance challenges confronting taxpayers and the IRS.

### BACKGROUND

When individual taxpayers acquire a tax liability and do not pay it timely, they enter into notice status and receive a series of up to four IRS notices requesting payment over a period of about six months. Most taxpayers respond by paying their debts in full.[4] Others contact the IRS to resolve their accounts, and as a result may enter into a payment agreement or be placed in currently not collectible status, if an IRS financial analysis determines

[3] The recession preceding the current economic downturn ended in November 2001. National Bureau of Economic Research, *US Business Cycle Expansions and Contractions*, *available at* http://www.nber.org/cycles/ (last visited Nov. 25, 2009).

[4] Over 60 percent of the taxpayers included in this study full paid their initial tax liability during the IRS notice process.

that they are unable to pay.[5] The IRS conducts financial analyses using a set of standards for allowable living expenses, which are updated annually.[6]

Taxpayers that do not resolve their delinquencies during notice status enter into taxpayer delinquent account status at the conclusion of the notice stream. Their accounts are evaluated and prioritized automatically by the Inventory Delivery System and are then placed in one of several possible statuses based on their priority.[7] The IRS shelves low priority cases and does not work them while they remain in that status, but may subsequently assign them another status to be worked when resources become available.[8] The highest priority cases are assigned to the Collection Field function to be worked by revenue officers. Other high priority cases are either routed to the Automated Collection System, a telephone-based inventory management system, or placed in the queue. Cases placed in the queue remain inactive until CFf resources become available to work them, unless the liabilities are satisfied by the offset of a refund or a subsequent taxpayer payment.[9]

Accounts worked while in TDA status are resolved with the same dispositions as accounts resolved while still in notice status: taxpayers pay in full, enter into payment agreements, or are placed in CNC status.[10]

## METHODOLOGY

TAS Research extracted individual taxpayer records with new liabilities becoming due during calendar year 2002 from the IRS Accounts Receivable Dollar Inventory (ARDI) module database, using the new record indicator on the database.[11] We compared these records to the ARDI entity database to remove taxpayers who had liabilities prior to 2002. We then added back taxpayer records if the prior liability was satisfied prior to 2002. The result was a cohort of taxpayers who became newly delinquent with balance due liabilities during 2002.[12]

We created a separate record for each distinct liability type and tax period. For example, a taxpayer with a new income tax liability and a new Trust Fund Recovery Penalty or with income tax liabilities from two different tax years would have two records.[13] Nevertheless, for the final analysis, we only analyzed one record per taxpayer. In the event that the taxpayer

5 Internal Revenue Manual (IRM) 5.15.1 (Oct. 2, 2009).

6 IRS, Collection Financial Standards, available at http://www.irs.gov/individuals/article/0,,id=96543,00.html (last visited Dec. 14, 2009).

7 IRM 5.1.1.13 (Aug. 21, 2006).

8 Cases may be resolved while in shelved status by offsets of refunds or subsequent taxpayer payments.

9 Cases in the queue may be subject to systemic IRS levies such as the Federal Payment Levy Program (FPLP) or the State Income Tax Levy Program.

10 The IRS may take enforcement action, such as the issuance of a levy or the seizure of property, against taxpayers' whose accounts reach TDA status. As discussed above, taxpayers are placed in CNC status when the IRS determines that they are unable to pay their tax liabilities. The IRS also places taxpayer accounts in CNC status when it is unable to locate the taxpayer.

11 This study does not include business liabilities, except for Trust Fund Recovery Penalties (TFRP) assessed against individual taxpayers in accordance with IRC § 6672.

12 Taxpayers had no prior unsatisfied balance due liabilities at the time that their 2002 balance due liabilities arose; however, they may have had unfiled return delinquencies.

13 Some taxpayers had more than one new balance due liability occur during 2002.

had multiple new balances due during 2002, the oldest income tax liability was included in the analysis. Taxpayers with more than one liability in 2002 may have experienced different dispositions for their liabilities. For example, a taxpayer may have full paid one liability, while being placed in an IA to pay another. In these instances, we used the oldest income tax liability per taxpayer for the analysis of the liability dispositions. Taxpayers may also experience more than one disposition of the same liability; for example, the IRS may have placed a taxpayer into an installment agreement, which ultimately fully paid the liability. For purposes of this report, the initial disposition is the one considered in the analysis.

We classified cases into five possible disposition types:

- Shelved;
- Full pay;
- Queue;
- Currently Not Collectible; and
- Installment agreement.

We determined if cases were shelved or reported as CNC cases from the presence of transaction code 530 and the corresponding closing code from the IRS IMF Transaction Code History table. Full pay, queue, and installment agreement cases were determined from the Master File status code in the IMF Status History table. We used the cycle date of each of the aforementioned disposition types to determine the first disposition and the last disposition of the case.

We determined the presence of subsequent liabilities by using the IRS ARDI module file and Individual Master File (IMF) Status Code History file.[14] A return was considered delinquent if unfiled by the due date (including extensions), since we could not reliably determine if a filing requirement existed.[15] Because data at the beginning of this project was only available through the thirteenth week of 2009, no tax year (TY) 2008 return was considered to have a filing delinquency. Any balance due delinquency occurring for TY 2002 (due in calendar year 2003) or later was considered to be a subsequent balance due delinquency, even if the new liability was paid during notice status.

The IRS determines allowable living expenses by summing separate allowances for housing and utilities, transportation, health care, and an allowance from the IRS "National Standards" (which cover items such as food and clothing).[16] We performed the analysis of IRS allowable living expenses by analyzing the taxpayer's income and expenses in the year

14 The IMF Status Code History file had incomplete data for calendar years 2002 and 2003. TAS Research used the ARDI module file to identify calendar year 2002 and 2003 balance due liabilities.

15 TAS Research could attempt to reconstruct taxpayer incomes using data from information returns, such as Forms W-2 for wages, and Forms 1099 for interest and dividend income, but taxpayers may have had cash income that would not be reported on an information return.

16 IRM 5.15.1 (Oct. 2, 2009).

the case was first disposed, or in the year the taxpayer filed bankruptcy or received cancellation of debt income (Form 1099-C).[17]

To approximate the IRS allowable living expenses analysis, we used the taxpayer's total positive income (TPI)[18] and created a proxy for the IRS ALE amount by using the number of taxpayer exemptions to determine household size (the household size is needed to determine the National Standards allowance and the Housing and Utility allowance) and the taxpayer ZIP Code to determine his or her county of residence (the county of residence is also needed to determine the Housing and Utility allowance). We used a commercial ZIP Code product to map a taxpayer's ZIP Code at time of the delinquency to the county of residence. The Housing and Utility allowable expense amount is the smaller of 30 percent of total positive income (from the return) or the IRS allowable expense amount.[19] The 30 percent of total positive income is the highest Census American Community Survey (from the Census Bureau American Fact Finder) allowance for housing expenses. In some instances, either the taxpayer's ZIP Code could not be matched to a county or the format of the county name differed from the format of the county name used by IRS. In these instances, the taxpayer's housing allowance was set at 30 percent of the taxpayer's total positive income. Transportation allowances were determined by using the average regional amount for ownership and operation of one or two cars. If the taxpayer had a spouse, two automobiles were allowed; otherwise only one was allowed. If applicable, health care expenses were based on the age of the taxpayer in accordance with IRM standards.[20]

We determined a taxpayer's ability to pay by subtracting the proxy for IRS allowable living expenses from the taxpayer's total positive income. If the amount was positive and the residual amount of income after subtracting the allowable expense proxy would satisfy the liability within five years (the default timeframe for streamlined IAs), the taxpayer was considered a "can pay" taxpayer. Otherwise, we considered the taxpayer to be a "cannot pay" taxpayer.

## FINDINGS

We present our findings in two sections. In the first section, we cover our findings on the subsequent compliance behavior of the taxpayers. We divide the study population into categories based on the initial IRS disposition of their liabilities, *e.g.*, some taxpayers full paid their initial liabilities during notice status, others entered into installment agreements with

17 Taxpayers with no return filed for the year of CODI, bankruptcy, or CNC were removed from the analysis.

18 TPI is calculated by summing the positive values from the following income fields from a taxpayer's most recently filed individual tax return: wages; interest; dividends; distribution from partnerships, small business corporations, estates, or trusts; Schedule C net profits; Schedule F net profits; and other income such as Schedule D profits and capital gains distributions. Losses reported for any of these values are treated as zero.

19 The IRS requires taxpayers to provide documentation to substantiate their housing and utility expenses. IRS allows the lesser of the documented actual expenses or the ALE allowance. We therefore used the Census American Community Survey to estimate the actual amount of housing expenses and used the estimate rather than the ALE allowance if the estimate was lower.

20 The IRS allows a higher allowance for taxpayers who are age 65 or over. We only had data for the age of the primary taxpayer, so other taxpayers are presumed to have the below age 65 health care allowance. The IRS began making an allowance for medical expenses in calendar year 2007.

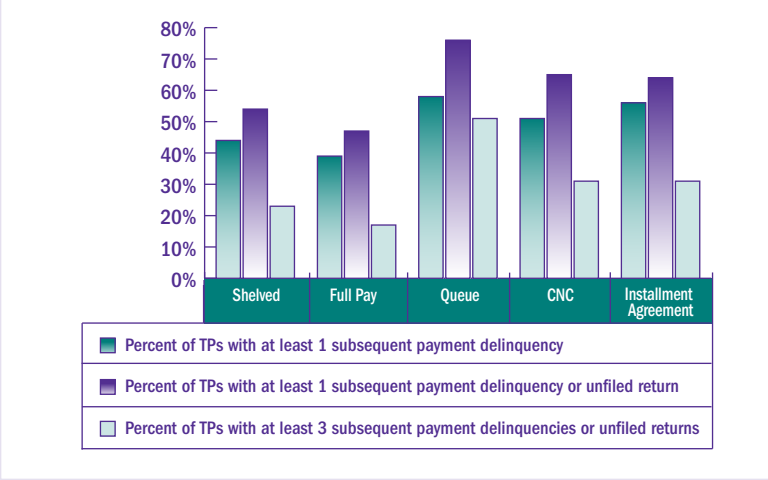
the IRS. In the second section, we present our findings on the adequacy of the IRS living expense guidelines in addressing the complete financial situation of taxpayers.

## SUBSEQUENT COMPLIANCE BEHAVIOR OF DELINQUENT TAXPAYERS

TAS Research looked at whether taxpayers incurred additional delinquencies after the IRS determined a disposition for their original liabilities.[21] We define delinquency as either non-payment of an assessed balance due on a timely basis or failure to file a return on a timely basis. It is important to note that we could not determine whether taxpayers had a filing requirement for unfiled returns, since we cannot reliably determine their incomes in the years they did not file.[22]

### Subsequent Noncompliance by Type of First Disposition of the Original Liability

**FIGURE 1: Taxpayers with Delinquencies**




**Shelved taxpayers** – There were 441,740, taxpayers who had their original tax liabilities shelved at first disposition. About 53 percent of these taxpayers had at least one subsequent payment delinquency or unfiled return. About 21 percent had at least three such delinquencies. When considering only subsequent payment delinquencies, 42 percent of these taxpayers accrued subsequent tax liabilities.

**Full pay taxpayers** – There were 4,026,083 taxpayers who full paid their original tax liabilities. About 46 percent of these taxpayers had at least one subsequent payment delin-

21 In many cases, the initial disposition of a case may change later on. For example, a case that was originally shelved might later be worked and enter into installment agreement or full pay status.

22 TAS Research could attempt to reconstruct taxpayer incomes using data from information returns, such as Forms W-2 for wages, and Forms 1099 for interest and dividend income, but taxpayers may have had cash income that would not be reported on an information return.

quency or unfiled return. About 17 percent had at least three such delinquencies. When considering only subsequent payment delinquencies, 39 percent of these taxpayers accrued subsequent tax liabilities.

**Taxpayers placed in queue** – There were 62,496 taxpayers who were placed in the queue at the time of first disposition. About 76 percent of these taxpayers had at least one subsequent payment delinquency or unfiled return. About 46 percent had at least three such delinquencies. When considering only subsequent payment delinquencies, about 54 percent of these taxpayers accrued subsequent tax liabilities.

**Taxpayers placed in CNC status due to hardship** – There were 25,450 taxpayers who were placed in CNC status due to hardship at first disposition.[23] About 59 percent of these taxpayers had at least one subsequent payment delinquency or unfiled return. About 26 percent had at least three such delinquencies. When considering only subsequent payment delinquencies, 45 percent of these taxpayers accrued subsequent tax liabilities.

We also examined the liability amount of taxpayers whose 2002 liabilities were reported as CNC due to hardship. Of these, 61 percent still had at least one payment delinquency as of the 44th week of 2009. At the time the original liability arose for these taxpayers in 2002, the median balance due amount was just under $3,500, while the median balance due in the last quarter of 2009 was nearly $8,600.[24]

**Taxpayers placed in an installment agreement** – There were 1,437,595 taxpayers who were placed in IAs at the time of first disposition. About 64 percent of these taxpayers had at least one subsequent payment delinquency or unfiled return. About 31 percent had at least three such delinquencies. When considering only subsequent payment delinquencies, 56 percent of these taxpayers accrued subsequent tax liabilities.

### Taxpayer Groups with Especially High Subsequent Noncompliance

As noted above, taxpayers whose accounts were placed in the queue or in CNC status at first disposition had high levels of subsequent noncompliance. In addition, all taxpayers whose liabilities reached TDA status and were worked in ACS or by the CFf had especially high levels of subsequent noncompliance, regardless of their disposition.[25] Taxpayers who had CODI or experienced bankruptcy at any time during the study period also had very high levels of subsequent noncompliance.

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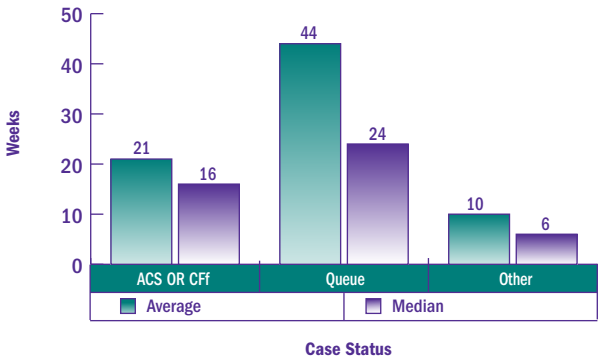
23 Another 197,136 taxpayers had liabilities that were reported CNC for reasons other than hardship.

24 While the 2009 liabilities may include new liabilities subsequent to those arising in 2002, this data shows that CNC dispositions often fail to bring taxpayers into compliance and can result in substantial additional revenue loss. This problem could be ameliorated if the original liability were satisfied through a collection alternative, such as an OIC, that required subsequent filing and payment compliance.

25 Taxpayers can enter into a disposition, such as full pay or CNC status, from either notice status of TDA status. Taxpayers whose accounts reached TDA status before initial disposition had much higher levels of subsequent noncompliance, regardless of the disposition of their liabilities.

When considering liabilities that were ultimately paid in full by the taxpayer, we also found that once balance due delinquencies reach ACS or the field, the time to dispose of these cases is much longer. On average, ACS or CFf took twice as many weeks to initially dispose of a new balance due case in 2002 as were required to dispose of cases that did not reach TDA status. The average time for ACS or CFf to initially dispose of a case where the taxpayer ultimately full paid the liability was 21 weeks and the median was 16 weeks. In contrast, the average time to initially dispose of other balance due delinquencies never in ACS, CFf, or the queue was only ten weeks and the median number was six weeks. For cases reaching TDA status but also spending time in the Collection queue, the average time to initially dispose of these cases was 44 weeks and the median time was 24 weeks.[26]

**FIGURE 2: Amount of Time to Initial Disposition of Delinquency Cases When Taxpayer Ultimately Full Pays Liability**




**Taxpayers whose liability reached TDA status** – There were 553,799 taxpayers whose initial liability reached TDA status. About 74 percent of these taxpayers had at least one subsequent payment delinquency or unfiled return. About 41 percent had at least three such delinquencies. When considering only subsequent payment delinquencies, 61 percent of these taxpayers accrued subsequent tax liabilities.

**Taxpayers who had CODI or experienced bankruptcy** – There were 538,744 taxpayers who had CODI or who experienced bankruptcy at some time during the study period. About 71 percent of these taxpayers had at least one subsequent payment delinquency or unfiled return. About 36 percent had at least three such delinquencies. When considering only subsequent payment delinquencies, 62 percent of these taxpayers accrued subsequent tax liabilities.

26 Includes only cases where the liability was ultimately full paid.

## IRS ALLOWABLE EXPENSES DO NOT FULLY REFLECT TAXPAYERS' FINANCIAL CONDITION

TAS Research conducted a simulated financial analysis to determine a taxpayer's ability to pay using IRS ALE standards. We determined the taxpayer's income using the taxpayer's total positive income as reported on his or her tax return.[27] We then developed an estimate of allowable expenses based on the ALE standards, and determined how much income the taxpayer had left over after allowable expenses. If the taxpayer had sufficient income left over to pay off his or her liability over five years, the default timeframe for streamlined installment agreements, we classified the taxpayer as a "can pay" taxpayer.[28]

We conducted this analysis on three different groups of financially stressed taxpayers: taxpayers who were placed in CNC status due to financial hardship, taxpayers who had CODI, and taxpayers who declared bankruptcy. We conducted the analyses during the year in which they experienced the financial stress (*e.g.*, if a taxpayer declared bankruptcy in 2003, we used the TY 2003 return and ALE standards to determine ability to pay).

**Taxpayers who were classified as CNC due to hardship** – About a quarter of CNC taxpayers show as "can pay" taxpayers in the year their modules were disposed of as CNC.[29] This result demonstrates that these taxpayers had additional expenses beyond those reflected in the ALE standards. While the IRS did allow these expenses, it would not have allowed any unsecured debt, which is included in the two groups below.

**Taxpayers with Unsecured Liabilities** – Because the IRS does not include unsecured debt and limits allowable housing expenses in the financial analyses that determine a taxpayer's ability to pay, it may in effect force some taxpayers to have to choose which creditors they will pay. This may result in taxpayer defaults on payment agreements and new tax delinquencies.

**Taxpayers with cancellation of debt income** – In all years during which taxpayers received CODI, at least 50 percent were identified as "can pay" taxpayers. In many cases, these taxpayers probably had liabilities they could not pay (*i.e.*, the debt underlying the CODI) that the IRS does not recognize, since only secured liabilities (*e.g.*, real estate and automobile loans) are included in ALE calculations.[30]

**Taxpayers who experienced bankruptcy** – In all years during which taxpayers declared bankruptcy, over 50 percent were identified as "can pay" taxpayers. In many cases, these

27 TPI is calculated by summing the positive values from the following income fields from a taxpayer's most recently filed individual tax return: wages; interest; dividends; distribution from partnerships, small business corporations, estates, or trusts; Schedule C net profits; Schedule F net profits; and other income such as Schedule D profits and capital gains distributions. Losses reported for any of these values are treated as zero.

28 IRM 5.14.5.2 1(c).

29 24.2 percent of CNC taxpayers showed as "can pay" in the year their modules were disposed of.

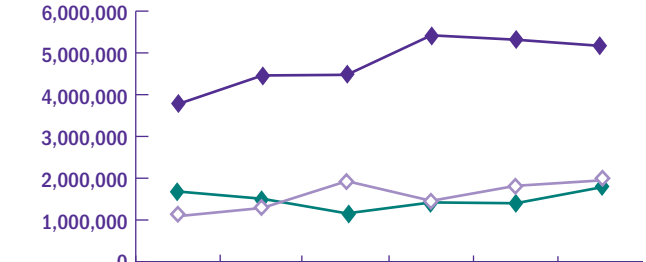
30 IRS allowable expense standards allow taxpayers set amounts for ownership and operation of up to two automobiles.

taxpayers probably had liabilities they could not pay that IRS does not recognize, since only secured liabilities (*e.g.*, real estate and automobile loans) are included in ALE calculations.

## COMPLIANCE CHALLENGES CURRENTLY FACING THE IRS

The IRS is experiencing high levels of new individual taxpayer payment delinquencies in categories that could produce high levels of subsequent noncompliance. Figure 3 below shows receipts by fiscal year (FY) of three categories of taxpayer delinquency cases that our research showed to have problematic subsequent noncompliance.

**FIGURE 3: Delinquencies with High Levels of Subsequent Noncompliance**[31]




| | FY 2004 | FY 2005 | FY 2006 | FY 2007 | FY 2008 | FY 2009 |
|---|---|---|---|---|---|---|
| TDA | 3,774,491 | 4,459,882 | 4,474,987 | 5,420,823 | 5,315,726 | 5,168,822 |
| Queue | 1,091,347 | 1,288,759 | 1,930,225 | 1,458,766 | 1,818,015 | 1,946,141 |
| CNC | 1,681,867 | 1,507,573 | 1,158,144 | 1,420,660 | 1,400,794 | 1,776,956 |

The number of taxpayers receiving CODI also is continuing to grow. Figure 4 shows the number of taxpayers who received COD income by tax year.

**FIGURE 4: Number of Taxpayers Receiving CODI (Form 1099-C) by Tax Year**[32]

| 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|
| 978,173 | 1,049,460 | 1,116,432 | 1,635,820 | 1,452,293 | 1,644,934 | 1,939,559 |

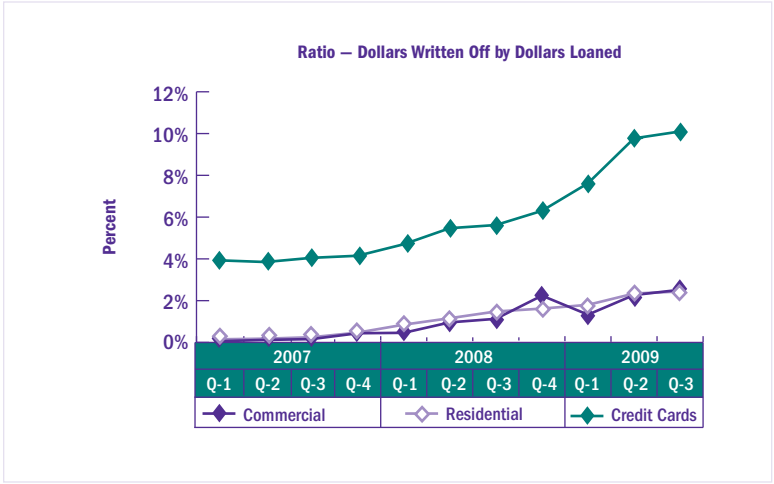
Recent data reported by the Federal Reserve Board show that many taxpayers are having difficulty meeting their financial obligations. Charge-off rates for both real estate and consumer loans are continuing to rise, as shown in Figure 5 below, suggesting that the number of taxpayers experiencing financial distress is still growing.

31 IRS, Small Business/Self-Employed (SB/SE) Division, *Collection Activity Report NO-5000-2/242, Taxpayer Delinquent Account Cumulative Report* (Sept. 28, 2008); SB/SE, *Collection Activity Report NO-5000-149, Recap of Accounts Currently Not Collectible Report* (Oct. 5, 2009). The counts for TDA, queue and CNC receipts overlap because some TDA receipts had queue or CNC dispositions during the year in which they were received.

32 TAS Research analyzed Information Returns Master File data available on the Compliance Data Warehouse to obtain the results presented in this table.

Credit card debt is particularly problematic for taxpayers, since the IRS does not include unsecured debt in its calculation of a taxpayer's ability to pay. Residential real estate debt may be problematic as well, since the IRS limits allowable housing expenses in the calculation.

**FIGURE 5: Real Estate and Consumer Loan Charge-Offs**[33]




Mortgage delinquencies and foreclosures also reflect that taxpayers are experiencing a high level of financial distress. The Mortgage Bankers Association (MBA) reported that 2009 third quarter delinquencies and foreclosures reached record highs (MBA data dates back to 1972):

> The percentages of loans 90 days or more past due, loans in foreclosure, and foreclosures started all set new record highs.
>
> The percentage of loans in the foreclosure process at the end of the third quarter was 4.47 percent, an increase of 17 basis points from the second quarter of 2009 and 150 basis points from one year ago. The combined percentage of loans in foreclosure or at least one payment past due was 14.41 percent on a non-seasonally adjusted basis, the highest ever recorded in the MBA delinquency survey.[34]

This challenging economic environment likely impedes taxpayers' ability to comply with their tax obligations, and suggests that new taxpayer payment delinquencies will remain high in the current fiscal year.

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33 Federal Reserve Statistical Release, *Charge-off Rates on Loans and Leases at Commercial Banks* (Not Seasonally Adjusted), *available at* http://www.federalreserve.gov/releases/chargeoff/chgallnsa.htm (last visited Nov. 25, 2009). Residential and commercial loans are real estate loans; credit cards are consumer loans.

34 Mortgage Bankers Association, Press Release: *Delinquencies Continue to Climb in Latest MBA National Delinquency Survey* (Nov. 19, 2009) *available at* http://www.mbaa.org/NewsandMedia/PressCenter/71112.htm (last visited Nov. 25, 2009).

## CONCLUSION

The TAS Research analysis tracked the subsequent compliance behavior of taxpayers who acquired an unpaid tax liability in 2002, and who did not have an outstanding prior liability at that time. Certain groups of taxpayers had high levels of subsequent noncompliance: taxpayers reaching TDA status; taxpayers who received COD income at any time during the study period; taxpayers placed in the queue, and taxpayers placed in CNC status.

A simulated financial analysis based on the ALE standards shows that many of these taxpayers have financial obligations that are not included in the standard ALE analysis, and suggests that many taxpayers may have liabilities that the IRS will not allow in its calculation of their ability to pay. The existence of these liabilities may contribute to subsequent noncompliant behavior, since the amount the taxpayer is required to pay to the IRS may put some taxpayers in the position of deciding which creditor they will pay.

Current elevated levels of payment noncompliance and taxpayer delinquencies on consumer and residential loans demonstrate that taxpayers are experiencing severe financial distress. The challenging economic environment and high levels of consumer and residential loan delinquencies suggest the IRS may need to offer more flexible payment arrangements to enable delinquent taxpayers to become and remain compliant with their tax obligations.

## RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS study of a representative sample of taxpayers with new payment delinquencies to determine the extent to which they have liabilities that are not allowed under current ALE standards. The study should also evaluate whether current IRS installment agreement policies would cause these taxpayers to default on non-IRS liabilities.

If the study results confirm that current IRS installment agreement policies are problematic, the National Taxpayer Advocate recommends that the IRS conduct a pilot study in which taxpayer payment agreements are based on a comprehensive review of the taxpayer's financial situation, with due consideration to all taxpayer liabilities.

The National Taxpayer Advocate also recommends that the IRS study the use of collection alternatives, such as the offer in compromise program and partial payment installment agreements, in lieu of placing taxpayers in CNC status. The agreements could be structured to have a finite duration and a flexible payment schedule contingent on the taxpayer's ability to pay throughout the duration of the agreement. The emphasis would be on ensuring that taxpayers remain current on future tax liabilities through the establishment of adequate withholding, or periodic direct debit estimated payments (*e.g.*, on a bi-weekly or monthly basis) for self-employed taxpayers.

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